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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

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**Quarterly Report Pursuant to Section 13 or 15(d) of  
the Securities Exchange Act of 1934**

**FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2000**

**Commission File No. 000-25945**

**NETWORK ACCESS SOLUTIONS CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**54-1738938**

(I.R.S. Employer  
Identification Number)

**100 Carpenter Drive  
Sterling, Virginia 20164**

(Address and zip code of principal executive offices)

**703-742-7700**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ☒ NO ☐

As of May 1, 2000, there were 46,961,368 shares of the Registrant's common stock ("Common Stock") outstanding.

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# NETWORK ACCESS SOLUTIONS CORPORATION

## INDEX

### FORM 10-Q

#### PART I – FINANCIAL INFORMATION

#### Page

##### Item 1. Financial Statements:

Balance Sheets as of March 31, 2000 and December 31, 1999 ..... 3

Statements of Operations and Other Comprehensive Income (Loss) for the three months  
ended March 31, 2000 and 1999 ..... 4

Statements of Cash Flows for the three months ended March 31, 2000 and 1999 ..... 5

Notes to Financial Statements ..... 6

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations ..... 12

Item 3. Quantitative and Qualitative Disclosures about Market Risk ..... 20

#### PART II – OTHER INFORMATION

Item 1. Legal Proceedings ..... 21

Item 2. Changes in Securities ..... 21

Item 3. Defaults Upon Senior Securities ..... 21

Item 4. Submission of Matters to a Vote of Security Holders ..... 21

Item 5. Other Information ..... 21

Item 6. Exhibits and Reports on Form 8-K ..... 21

Signatures ..... 22

**PART I – FINANCIAL INFORMATION**  
**ITEM 1. FINANCIAL STATEMENTS**

**NETWORK ACCESS SOLUTIONS CORPORATION**  
**BALANCE SHEETS**

	As of March 31, 2000 (unaudited)	As of December 31, 1999
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 92,604,565	\$ 18,240,096
Short-term investments .....	68,106,503	24,575,893
Accounts receivable, net of allowance for doubtful accounts of \$724,266 and \$376,399 as of March 31, 2000 and December 31, 1999, respectively .....	4,529,048	3,257,204
Inventory .....	1,135,911	440,770
Prepaid and other current assets .....	<u>1,413,768</u>	<u>927,218</u>
Total current assets .....	167,789,795	47,441,181
Property and equipment, net .....	68,765,438	55,097,670
Restricted cash .....	1,600,000	1,600,000
Deferred offering costs .....	–	259,272
Deposits .....	156,823	72,554
Income tax receivable .....	149,186	27,600
Deferred tax asset .....	–	<u>121,586</u>
Total assets .....	<u>\$ 238,461,242</u>	<u>\$ 104,619,863</u>
<b>LIABILITIES, MANDATORILY REDEEMABLE PREFERRED STOCK, AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable .....	\$ 4,693,586	\$ 8,221,681
Accrued expense .....	6,024,905	4,118,746
Current portion of deferred compensation liability .....	166,667	166,667
Current portion of capital lease obligations .....	7,529,140	5,630,429
Current portion of note payable .....	615,588	478,925
Other current liabilities .....	335,101	247,678
Deferred revenue .....	<u>151,695</u>	<u>42,788</u>
Total current liabilities .....	19,516,682	18,906,914
Long term portion of capital lease obligations .....	18,995,267	15,251,100
Long-term portion of note payable .....	<u>2,316,548</u>	<u>2,453,211</u>
Total liabilities .....	<u>40,828,497</u>	<u>36,611,225</u>
Commitments and contingencies:		
Series B mandatorily redeemable preferred stock, \$0.001 par value, 1,500,000 and 0 shares authorized, issued and outstanding (liquidation preference \$150,000,000 (unaudited)) as of March 31, 2000 and December 31, 1999, respectively .....	<u>150,488,459</u>	<u>–</u>
Stockholders' equity:		
Common stock, \$0.001 par value, 150,000,000 shares authorized, 55,297,063 and 53,831,997 shares issued and outstanding as of March 31, 2000 and December 31, 1999, respectively .....	55,297	53,832
Additional paid-in capital .....	139,115,605	130,431,898
Accumulated other comprehensive loss .....	(41,120)	(51,960)
Deferred compensation on employee stock options .....	(25,642,560)	(18,389,540)
Accumulated deficit .....	(64,442,936)	(42,135,592)
Less treasury stock, at cost, 8,550,000 shares as of March 31, 2000 and December 31, 1999 .....	<u>(1,900,000)</u>	<u>(1,900,000)</u>
Total stockholders' equity .....	<u>47,144,286</u>	<u>68,008,638</u>
Total liabilities, mandatorily redeemable preferred stock and stockholders' equity .....	<u>\$ 238,461,242</u>	<u>\$ 104,619,863</u>

The accompanying notes are an integral part of these financial statements.

# NETWORK ACCESS SOLUTIONS CORPORATION

## STATEMENTS OF OPERATIONS AND OTHER COMPREHENSIVE INCOME (LOSS)

(unaudited)

	For the three months ended March 31,	
	2000	1999
Revenue:		
Product sales and consulting services .....	\$ 4,741,969	\$ 4,656,773
Network services .....	<u>1,684,248</u>	<u>119,394</u>
Total revenue .....	<u>6,426,217</u>	<u>4,776,167</u>
Cost of revenue:		
Product sales and consulting services .....	4,055,560	3,834,697
Network services .....	<u>3,980,913</u>	<u>170,846</u>
Total cost of revenue .....	<u>8,036,473</u>	<u>4,005,543</u>
Gross profit (loss) .....	(1,610,256)	770,624
Operating expenses:		
Selling, general and administrative .....	14,930,042	2,532,519
Amortization of deferred compensation on stock options .....	1,699,081	540,469
Depreciation and amortization .....	<u>3,868,469</u>	<u>186,710</u>
Loss from operations .....	(22,107,848)	(2,489,074)
Interest income .....	1,143,085	54,312
Interest expense .....	(768,858)	(62,956)
Follow-on offering costs .....	<u>(573,723)</u>	<u>—</u>
Net loss .....	(22,307,344)	(2,497,718)
Preferred stock dividends .....	690,411	197,260
Preferred stock accretion .....	<u>6,865</u>	<u>149,643</u>
Net loss applicable to common stockholders .....	<u>\$ (23,004,620)</u>	<u>\$ (2,844,621)</u>
Net loss per common share applicable to common stockholders (basic and diluted) .....	<u>\$ (0.50)</u>	<u>\$ (0.08)</u>
Weighted average common shares outstanding (basic and diluted) .....	<u>45,968,517</u>	<u>36,000,000</u>
Comprehensive loss:		
Net loss .....	\$ (22,307,344)	\$ (2,497,718)
Other comprehensive income:		
Unrealized gain on short-term investments .....	<u>10,840</u>	<u>—</u>
Total comprehensive loss .....	<u>\$ (22,296,504)</u>	<u>\$ (2,497,718)</u>

The accompanying notes are an integral part of these financial statements.

# NETWORK ACCESS SOLUTIONS CORPORATION

## STATEMENTS OF CASH FLOWS (unaudited)

	For the three months ended March 31,	
	2000	1999
Cash flows from operating activities:		
Net loss .....	\$ (22,307,344)	\$ (2,497,718)
Adjustment to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization expense .....	3,868,469	186,710
Provision for doubtful accounts receivable .....	387,564	43,439
Amortization of deferred compensation on stock options .....	1,699,081	540,469
Follow-on offering costs .....	573,723	-
Net changes in assets and liabilities:		
Accounts receivable .....	(1,659,408)	(952,389)
Inventory .....	(695,141)	(64,127)
Prepaid and other current assets .....	(486,550)	(320,549)
Deposits .....	(84,269)	-
Accounts payable .....	(3,528,095)	2,950,183
Accrued expenses .....	1,556,159	108,152
Deferred revenue .....	108,907	146,029
Other current liabilities .....	<u>87,423</u>	<u>(4,694)</u>
Net cash (used in) provided by operating activities .....	<u>(20,479,481)</u>	<u>135,505</u>
Cash flows from investing activities:		
Purchases of short-term investments .....	(43,519,770)	-
Expenditures for network under development .....	(6,944,705)	(4,291,325)
Purchases of property and equipment .....	<u>(3,542,420)</u>	<u>(674,996)</u>
Net cash used in investing activities .....	<u>(54,006,895)</u>	<u>(4,966,321)</u>
Cash flows from financing activities:		
Borrowings on notes payable .....	30,000,000	-
Repayments of notes payable .....	(30,000,000)	-
Principal payments on capital leases .....	(1,406,234)	(69,630)
Issuance of mandatorily redeemable preferred stock .....	150,000,000	-
Issuance costs related to preferred stock offering .....	(108,817)	-
Issuance costs related to follow-on offering .....	(64,451)	-
Exercise of stock options .....	<u>430,347</u>	<u>-</u>
Net cash provided by (used in) financing activities .....	<u>148,850,845</u>	<u>(69,630)</u>
Net increase (decrease) in cash and cash equivalents .....	74,364,469	(4,900,446)
Cash and cash equivalents at the beginning of the period .....	<u>18,240,096</u>	<u>5,518,117</u>
Cash and cash equivalents at the end of the period .....	<u>\$ 92,604,565</u>	<u>\$ 617,671</u>
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest .....	\$ 637,458	\$ 22,637
Non-cash investing and financing activities:		
Capital leases .....	7,049,112	174,649
Preferred stock dividends .....	690,411	197,260
Preferred stock accretion .....	6,865	149,643
Expenditures for offering costs included in accounts payable .....	550,000	246,314
Expenditures for network included in accounts payable .....	-	108,704

The accompanying notes are an integral part of these financial statements.

# NETWORK ACCESS SOLUTIONS CORPORATION

## NOTES TO FINANCIAL STATEMENTS (unaudited)

### 1. Business

Network Access Solutions Corporation, or the Company, was originally incorporated in the Commonwealth of Virginia on December 19, 1994. On August 3, 1998, the Company reincorporated in the State of Delaware. Prior to the reincorporation, the Company had authorized 10,000 shares of common stock, of which 7,803 shares were issued and outstanding. As of August 3, 1998, the Company was recapitalized with authorized capital stock of 15,000,000 shares of common stock, \$.001 par value per share and 10,000,000 shares of preferred stock, \$.001 par value per share. On March 18, 1999, the Company increased the authorized common stock to 50,000,000 shares with a par value of \$.001 per share. In conjunction with this reincorporation and recapitalization, the Company changed from a July 31 year-end to a calendar year-end. On March 18, 1999, the Company and its Board of Directors declared a two for one stock split, effected as a stock dividend, of its common stock. On May 7, 1999, the Company and its Board of Directors declared a 2.25 for one stock split, effected as a stock dividend, of its common stock. All share information has been retroactively adjusted for all periods presented to reflect the new capital structure and stock splits.

The Company, which is a major provider of high-speed data communications services and related applications, provides network services, telecommunications products and equipment and consulting services to business customers. Through its CopperNet branded service, the Company offers its customers high-speed connectivity using Digital Subscriber Line (DSL) technology. The Company provides metropolitan area and wide area network services, manages and monitors its customers' networks, sells telecommunications equipment, designs networks for its customers, installs the equipment and provides related services. The Company currently offers its DSL-based networking solutions in the following nine cities and their surrounding markets: Baltimore, Boston, New York, Norfolk, Philadelphia, Pittsburgh, Richmond, Washington, D.C., and Wilmington. The Company is in the process of expanding its geographical coverage to the southeastern and western U.S. markets.

### 2. Summary of Significant Accounting Policies

#### *Unaudited Interim Financial Statements*

The unaudited balance sheet as of March 31, 2000, the unaudited statements of operations for the three months ended March 31, 2000 and 1999 and the unaudited statement of cash flows for the three months ended March 31, 2000 and 1999 have been prepared in accordance with generally accepted accounting principles for interim financial information and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles, and it is suggested that these financial statements be read in conjunction with the financial statements and related notes included in the Company's annual report on Form 10-K for the year ended December 31, 1999. In the opinion of management, all adjustments (consisting of only normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2000 are not necessarily indicative of results that may be expected for the year ending December 31, 2000.

#### *Revenue Recognition*

The Company's revenue is derived from product sales and consulting services and from network services. The Company recognizes revenue on the sale of its products when a valid purchase order is received, shipment occurs, collection is probable and no significant obligations remain related to the completion of installation and performance of support services. The Company provides consulting services, including network planning, design, and integration services, under time-and-material type contracts and recognizes revenue as services are performed and as costs are incurred.

The Company provides network services, including DSL-based services, under monthly and fixed rate service contracts. Revenue on monthly contracts is recognized when services are performed. Revenue on fixed rate service contracts is recognized as costs are incurred over the related contract period, which generally does not exceed one

year. Payments received in advance of providing services are recorded as deferred revenue until the period in which such services are provided. Revenue related to installation and activation fees are recognized to the extent of incremental direct costs incurred. Any excess installation and activation fees over direct costs are deferred and amortized over the service contract. Such revenue historically has not significantly exceeded the direct costs. In certain situations, the Company will waive non-recurring installation and activation fees in order to obtain a sale. The Company will expense the related direct costs as incurred.

#### *Property and Equipment*

Property and equipment consists of network costs associated with the development and implementation of the DSL networks, office and computer equipment, and furniture and fixtures. The costs associated with the DSL network under development are composed of collocation fees, equipment, equipment held under capital leases, and equipment installation. These assets are stated at cost. The Company leases certain of its equipment under capital lease agreements. The capital lease assets are stated at the lower of the present value of the net minimum lease payments or the fair value at the inception of the lease, and are depreciated over the shorter of the estimated useful life or the lease term. Depreciation of office and computer equipment and furniture and fixtures is computed using the straight-line method, generally over three to five years, based upon estimated useful lives, commencing when the assets are placed in service. The depreciation of the DSL network costs commences as individual network components are placed in service and are depreciated over two to five years. Expenditures for maintenance and repairs are expensed as incurred. When assets are retired or disposed, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in operations for the period.

#### *Net Loss Per Share*

The Company presents basic and diluted net loss per share. Basic net loss per share is computed based on the weighted average number of outstanding shares of common stock. Diluted net loss per share adjusts the weighted average for the potential dilution that could occur if stock options, warrants or other convertible securities were exercised or converted into common stock. Diluted net loss per share for the three months ended March 31, 2000 and 1999, is the same as basic net loss per share because the effects of such items were anti-dilutive.

#### *Stock-Based Compensation*

The Company measures compensation expense for its employee stock-based compensation using the intrinsic value method and provides pro forma disclosures of net loss as if the fair value method had been applied in measuring compensation expense. Under the intrinsic value method of accounting for stock-based compensation, when the exercise price of options granted to employees is less than the estimated fair value of the underlying stock on the date of grant, deferred compensation is recognized and is amortized to compensation expense over the applicable vesting period.

#### *Segment Reporting*

The Company has determined its reportable segments based on the Company's method of internal reporting, which disaggregates its business by product category. The Company's reportable segments are: (i) network services, and (ii) product sales and consulting services. The network services segment provides local, metropolitan and wide area data communications services to customers. This segment also provides a wide variety of other services to customers, including remote network management and monitoring, network security, virtual private networks, e-commerce and CopperNet, the Company's high-speed, continuously connected DSL access to telecommunications networks. The product sales and consulting services segment provides sales of selected equipment from manufacturing partners, as well as nonrecurring service activation and installation, network integration, on site network management, network security consulting and professional services. Engineers select product solutions based upon customized network designs to improve the customers' operations and network efficiencies. In addition, the product sales and consulting services segment provides maintenance and installation of equipment, some of which may be provided through third party providers under contract. The Company's business is currently conducted principally in the eastern United States. There are no foreign operations.

### 3. Property and Equipment

Property and equipment consists of the following:

	As of March 31, 2000 (unaudited)	As of December 31, 1999
Network placed in service . . . . .	\$ 51,804,617	\$ 40,291,575
Network development in process . . . . .	14,790,880	12,790,617
Office and computer equipment . . . . .	9,313,667	5,925,278
Furniture and fixtures . . . . .	2,062,898	1,428,356
Less accumulated depreciation . . . . .	(9,206,624)	(5,338,156)
Property and equipment, net . . . . .	<u>\$ 68,765,438</u>	<u>\$ 55,097,670</u>

The Company's network includes equipment under capital leases, equipment, installation, and collocation fees. Collocation fees represent nonrecurring fees paid to obtain central office space for location of certain equipment. When a new portion of the Company's network has been completed and made available for use, the related cost is transferred from network development in process to network placed in service. As of March 31, 2000 and December 31, 1999, the recorded cost of the network equipment under capital leases was \$28,898,153 and \$22,939,012, respectively. Accumulated amortization for this equipment under capital leases was \$4,750,941 and \$2,998,446 as of March 31, 2000 and December 31, 1999, respectively.

### 4. Stock-Based Compensation

On July 23, 1998, the Company adopted the 1998 Incentive Stock Plan (the "Plan"), under which incentive stock options, non-qualified stock options, stock appreciation rights, restricted or unrestricted stock awards, phantom stock, performance awards or any combination thereof may be granted to the Company's employees and certain other persons in accordance with the Plan. The Board of Directors, which administers the Plan, determines the number of options granted, the vesting period and the exercise price. The Board of Directors may terminate the Plan at any time. With respect to options granted prior to February 15, 2000, options granted under the Plan are immediately exercisable into restricted shares of the Company's common stock upon award and expire ten years after the date of grant. The restricted common stock generally vests over a three or four year period. Subsequent to exercise, unvested shares of restricted stock cannot be transferred until such shares have vested. Upon voluntary termination, unvested shares of restricted stock can be repurchased by the Company at the lower of fair value or the exercise price. Options granted subsequent to February 15, 2000, under the Company's "Year 2000 Program" of administering the Plan, vest and are exercisable cumulatively over a three-year period commencing with the first anniversary of the date of grant, and expire ten years after the date of grant. At December 31, 1998, 9,000,000 shares were reserved for issuance under the Plan. Effective November 1, 1999 and subject to stockholder approval, the Company increased the number of shares of common stock reserved for issuance under the Plan to 13,250,000.

As of March 31, 2000 and December 31, 1999, a total of 10,499,338 and 10,972,791, respectively, of stock options had been granted at exercise prices ranging from \$.09 to \$32.00 per share. At March 31, 2000, 10,125,088 of these options were exercisable into restricted shares of our common stock that generally vest over a three- to four-year period. Stock option activity was as follows:

	Stock Options	Range of Exercise Prices	Weighted Average Exercise Price
Options outstanding, December 31, 1999 . . . . .	10,972,791	\$ 0.09 – 32.00	\$ 2.27
Options granted, January 2000 . . . . .	313,100	\$ 16.19 – 34.50	\$ 25.46
Options granted, February 2000 . . . . .	663,150	\$ 16.19 – 31.50	\$ 18.66
Options granted, March 2000 . . . . .	348,200	\$ 16.00 – 30.25	\$ 26.16
Options exercised . . . . .	(1,541,750)	\$ 0.09 – 16.19	\$ 0.25
Options canceled . . . . .	(256,153)	\$ 0.09 – 32.00	\$ 6.74
Options outstanding, March 31, 2000 . . . . .	<u>10,499,338</u>	<u>\$ 0.09 – 32.00</u>	<u>\$ 4.40</u>



In certain instances, the Company has determined the fair value of the underlying common stock on the date of grant was in excess of the exercise price of the options. As a result, the Company recorded deferred compensation of \$8,952,101 and \$11,944,082 for the three months ended March 31, 2000 and 1999, respectively. This amount was recorded as an increase to additional paid-in capital and is being amortized as a charge to operations over the vesting periods which range from three to four years of the underlying restricted common stock. The Company recognized stock compensation expense of \$1,699,081 and \$540,469 for the three months ended March 31, 2000 and 1999, respectively.

SFAS No. 123, Accounting for Stock-Based Compensation, encourages adoption of a fair value-based method for valuing the cost of stock-based compensation. However, it allows companies to continue to use the intrinsic value method for options granted to employees and disclose pro forma net loss and loss per share. Had compensation cost for the Company's stock-based compensation plans been determined consistent with SFAS No. 123, the Company's net loss and loss per share would have been as follows:

	For the three months ended March 31,	
	2000	1999
Net loss applicable to common stockholders, as reported . . . . .	\$ (23,004,620)	\$ (2,844,621)
Pro forma net loss applicable to common stockholders . . . . .	(24,855,897)	(2,854,984)
Net loss per share applicable to common stockholders, as reported, basic and diluted . . . . .	(0.50)	(0.08)
Pro forma net loss per share applicable to common stockholders, basic and diluted . . . . .	(0.54)	(0.08)

The weighted-average fair value of options granted during the three months ended March 31, 2000 and 1999 was approximately \$23.24 and \$6.27, respectively, based on the Black-Scholes option pricing model. Upon termination, unvested shares of restricted stock are repurchased by the Company at the lower of the exercise price or fair market value.

The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants during the three months ended March 31, 2000 and 1999: Dividend yield of 0%; expected volatility of 92%; risk-free interest rates of 5.85% to 6.74%; and expected term of five years.

As of March 31, 2000 and 1999, the weighted average remaining contractual life of the options is 8.8 and 9.6 years, respectively.

## 5. Note Payable

The Company has a \$5,000,000 line of credit agreement with Lucent Technologies, Inc. (Lucent), through its acquisition of Ascend Communications, Inc. (Ascend). As of March 31, 2000, the Company's total obligation under this agreement for working capital was \$2,932,136.

In connection with the Company's strategic financing agreement with SBC Communications, Inc. (SBC) and Teléfonos de México, S.A. de C.V. (Telmex), SBC and Telmex loaned the Company a total of \$30 million (\$15 million each) until it received the necessary regulatory approvals to complete the preferred stock sale. The loans bore interest at a rate of prime plus 2% during the time they were outstanding. Upon obtaining the regulatory approvals, the Company exchanged the loans for preferred stock and received the remaining proceeds upon the consummation of the preferred stock sale on March 7, 2000, net of the principal and accrued interest on these interim borrowings.

## 6. Mandatorily Redeemable Preferred Stock and Stockholders' Equity

On March 7, 2000, the Company issued 1,500,000 shares of Series B Mandatorily Redeemable Preferred Stock (preferred stock) for total proceeds of \$150,000,000 excluding direct issuance costs of \$208,817, of which \$100,000 is accrued as of March 31, 2000.

The convertible preferred stock is non-voting and pays a 7.0% dividend, which can be satisfied with either additional stock or cash. Each \$100.00 share of preferred stock is convertible at any time at the election of the holder into 3.2258 shares of the Company's common stock, or a total of 4,838,700 common shares. The preferred stock may be called by the Company for mandatory conversion into its common stock at any time between two and five years after the original issue date, provided the Company's common stock is trading above \$31.00 per share. On each anniversary of the issue date, beginning on the second anniversary and ending on the seventh anniversary, the holders of the preferred stock may request that the Company redeem the shares for a cash amount equal to \$100 per share plus unpaid dividends. The Company may postpone such right until the following year for all but the seventh year if its common stock share price is below \$31.00 for a specified period preceding the anniversary date. The Company has agreed to use 50% of the proceeds from the preferred stock to more closely align its network and business operations with the future network and business operations of both SBC and Telmex. If SBC and Telmex convert their preferred stock positions into the Company's common stock, SBC will own approximately 4.8% and Telmex will own approximately 4.5% of the Company's equity on a fully diluted basis. SBC and Telmex have the right to maintain their percentage equity ownership interests in the Company's common stock through a right of primary offer mechanism in the financing agreement. This right permits them to purchase, in any subsequent offering of the Company's stock, on the same terms and conditions as the stock is offered to third parties, an amount of stock that will allow them to maintain their respective percentage ownership interests. Through a separate agreement with the Company's present principal stockholders, Spectrum Equity Investors II, L.P. and Jonathon P. Aust, the Company's Chief Executive Officer, SBC and Telmex also have a right of first offer to purchase, in certain circumstances, any shares that these stockholders may wish to sell in the future.

The Preferred Stock activity is summarized as follows:

	<u>Shares</u>	<u>Amount</u>
Balance, December 31, 1999 .....	—	\$ —
Issuance of shares .....	1,500,000	150,000,000
Issuance costs .....	—	(208,817)
Accrued dividends .....	—	690,411
Accretion to redemption price .....	—	6,865
Balance, March 31, 2000 .....	<u>1,500,000</u>	<u>\$ 150,488,459</u>

## 7. Segment Information

In accordance with SFAS No. 131, the Company discloses certain segment information. The Company evaluates the performance of its segments and allocates resources to them based on gross profit. There are no intersegment revenues. The table below presents information about the reported gross profit (loss) of the Company's reportable segments for the three months ended March 31, 2000 and 1999. The Company has changed its internal organization in a manner that caused the composition of its reportable segments to change from three to two reportable segments. The corresponding information for earlier periods has been restated to conform to the new presentation of two reportable segments. Asset information is not reported for the product sales and consulting services segment, as this data is not considered by the Company in making its decisions regarding operating matters.

	Product Sales and Consulting Services	Network Services	Reconciling Items	Total
As of and for the three months ended March 31, 2000:	(unaudited; dollars in thousands)			
Revenue . . . . .	\$ 4,742	\$ 1,684	\$ —	\$ 6,426
Gross Profit (1) . . . . .	\$ 686	\$ (2,296)	\$ —	\$ (1,610)
Property and equipment, net . . . . .	\$ —	\$ 59,182	\$ 9,583	\$ 68,765
As of and for the three months ended March 31, 1999:				
Revenue . . . . .	\$ 4,657	\$ 120	\$ —	\$ 4,777
Gross profit (1) . . . . .	\$ 822	\$ (51)	\$ —	\$ 771
Property and equipment, net . . . . .	\$ —	\$ 9,264	\$ 830	\$ 10,094

- (1) Adjustments that are made to the total of the segments gross profit in order to arrive at income (loss) before income taxes are as follows:

	For the three months ended March 31,	
	2000	1999
	(unaudited; dollars in thousands)	
Gross profit (loss) . . . . .	\$ (1,610)	\$ 771
Operating expenses:		
Selling, general and administrative . . . . .	14,930	2,532
Amortization of deferred compensation . . . . .	1,699	540
Depreciation and amortization . . . . .	3,869	188
Income (loss) from operations . . . . .	(22,108)	(2,489)
Interest income . . . . .	1,143	54
Interest expense . . . . .	(769)	(63)
Follow-on offering costs . . . . .	(573)	—
Income (loss) before income taxes . . . . .	\$ (22,307)	\$ (2,498)

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and the related notes included elsewhere in this Form 10-Q and the financial statements and related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Form 10-K. Historical results and percentage relationships among any amounts in the Financial Statements are not necessarily indicative of trends in operating results for any future period.

### **Overview**

We began operations in 1995 by selling data communications products made by others and providing consulting services for WANs. Shortly thereafter, we began offering a wide range of networking solutions for the data communications needs of businesses. We provide network integration services, where we design our customers' networks and sell and install related network equipment. We also manage our customers' networks, ensure the security of their networks and provide related professional services. From 1995 through 1998, our revenue was derived primarily from product sales and consulting services. In prior periods, our business had primarily depended on AT&T and AstraZeneca for revenue from our product sales and consulting services operations. AT&T accounted for 5.2% and 55.5% of total revenue for the three months ended March 31, 2000 and 1999, respectively, while AstraZeneca accounted for 4.7% and 10.0% of total revenue for the three months ended March 31, 2000 and 1999, respectively.

In 1996, we began to pursue deployment of a series of city-wide networks that enable DSL services. In February 1997, we began developing technical standards for delivery of DSL-based services within our target markets through a joint effort with Bell Atlantic. In April 1997, we entered into our first interconnection agreement with Bell Atlantic, which allowed us to use their copper telephone lines and to collocate our equipment in telephone company offices known as "central offices." Central offices serve as the central connection point for all copper telephone lines in a local area and form the basis for our network and a telephone company's network. We began CopperNet service trials in November 1997 and began commercially offering our CopperNet service in Philadelphia and Washington, D.C. in January 1999.

We currently offer our DSL-based networking solutions in the following nine northeast and mid-Atlantic cities and their surrounding markets: Baltimore, Boston, New York, Norfolk, Philadelphia, Pittsburgh, Richmond, Washington D.C. and Wilmington. On February 8, 2000, in connection with the announcement of a \$150 million preferred stock investment by, and a strategic summary operating agreement with SBC and Telmex, we announced that we would be extending our network deployment into the southeastern and western regions of the United States. We, along with SBC and Telmex, have initially targeted deployment in the following 20 markets within these regions: Atlanta, Charlotte, Denver, Greensboro, Jacksonville, Louisville, Memphis, Miami, Minneapolis, Nashville, New Orleans, Orlando, Phoenix, Portland, Raleigh-Durham, Salt Lake City, Seattle, Tampa, Tucson and West Palm Beach. We intend to deploy our network in each of these markets in the second half of 2000.

As of March 31, 2000, we had installed our equipment in 477 central offices within our northeast and mid-Atlantic markets, and we expect to have installed our equipment in approximately 500 central offices by mid-2000, which will essentially complete our current plans for the roll-out of our network in these markets. We estimate that the central offices where we currently have installed our equipment serve approximately 85% of the business users in these areas. Upon the completion of our network deployment, we believe that the central offices where we have installed our equipment will be able to serve approximately 95% of the business users in these areas. As of March 31, 2000, we had installed 4,888 lines in our northeast and mid-Atlantic regions.

We expect to have installed our equipment in approximately 500 central offices in our new southeastern and western regions by mid-2001. We have obtained competitive carrier certification in eight of the 17 southeastern and western states in which we expect to eventually offer services, and have applied for competitive carrier certification in the remaining nine states in which these markets are located. To date, we have signed interconnection agreements with BellSouth, U S WEST and GTE. Together, these three carriers serve as the traditional telephone companies in substantially all of our 20 target markets in the southeastern and western regions.

Since February 1997, we have invested increasing amounts in the development and deployment of our CopperNet service. We have funded the deployment of our CopperNet services through proceeds received from a preferred and common stock financing in August 1998, issuance of promissory notes that were converted into common stock during the three months ended June 30, 1999, capital lease financing, our initial public offering and the proceeds recently received from the sale of \$150 million of our Series B Mandatorily Redeemable Preferred Stock (preferred stock) to SBC and Telmex. We intend to increase our operating expenses and capital expenditures substantially in an effort to continue to rapidly expand our equipment and human resource-related infrastructure and DSL-based network services. We expect to continue to incur substantial operating losses, net losses and negative cash flow during the build-out of our network and our initial penetration of each new market we enter. Although in the short term we expect to derive the majority of our revenue from our product sales and related consulting services, we expect that over time revenue from network services, which includes our CopperNet services, will constitute the more significant portion of our total revenue.

## **Revenue**

Revenue consists of:

- *Network services.* We charge monthly service fees for access to our CopperNet local, metropolitan and wide area networks. We also provide a wide variety of network services to customers, including remote network management and monitoring, network security, dedicated private connections to our network, Internet access, e-commerce and other data applications. Some of these services are delivered to customers using resources from third-party providers under contract to us.
- *Product sales and Consulting services.* As part of our overall data communications solutions, we sell data communications products, including the network components and security components that our customers require in order to build, maintain and secure their networks. We sell, install and configure selected equipment from our manufacturing partners. Our engineers select product solutions to improve our customers' operations and network efficiencies. Our engineers refer to a standard network design that they seek to customize to fit the needs of each customer. We also bill our customers for network design and integration, on-site network management, staging, installation, maintenance and warranty services, network security and professional services based on time and materials for contracted services. In addition, we derive revenue from the maintenance and installation of equipment. Some of these services may be provided through third-party providers under contract to us.

## **Cost of Revenue**

Cost of revenue consists of:

*Network services.* Our network service costs generally consist of non-employee-based charges such as:

- *CopperNet service fees.* We pay a monthly service fee for each copper line and for each collocation arrangement, as well as usage fees for the support services we obtain from the traditional telephone companies we work with in order to serve our CopperNet customers. Sometimes, we must pay these companies to perform special work, such as preparing a telephone line to use DSL technology, when such work is required in order to serve a particular client.
- *Other access costs and levied line expense.* We pay installation charges and monthly fees to competitive telecommunications companies or traditional telephone companies for other types of access, other than through our CopperNet network, which we provide to customers as part of our network services.
- *Backbone connectivity charges.* We incur charges for our fiber optic network, or backbone, within a metropolitan area, typically from a competitive telecommunications company or a traditional telephone company, and for the backbone interconnecting our networks in different metropolitan areas from a long distance carrier. We pay these carriers a one-time installation and activation fee and a monthly service fee for these leased network connections.

- *Network operations expenses.* We incur various recurring costs at our network operations center. These costs include data connections, engineering supplies and certain utility costs.
- *Equipment operating lease expenses.* In the future, we may decide to enter into operating leases for some or all of the equipment we use in our network, including the DSL equipment we use in the traditional telephone company's central office locations and equipment installed on the customer's premises. Currently, we generally use capital leases to finance the acquisition of substantially all of this equipment, which we depreciate over a range of two to five years.

*Product sales and Consulting services.* We purchase equipment from various vendors whose technology and hardware solutions we recommend to our customers. We do not manufacture any of this equipment. Consulting services cost of revenue consists of charges for hardware maintenance, installation and certain contract services that we purchase from third parties.

## **Operating Expenses**

### *Selling, general and administrative expenses*

Our selling, general and administrative expenses include all employee-based charges, including field technicians, engineering support, customer service and technical support, information systems, billing and collections, general management and overhead and administrative functions. We expect that headcount in functional areas, such as sales, customer service and operations will increase significantly as we expand our network and as the number of customers increases.

- *Sales and marketing expenses.* We distribute our products and services through direct and indirect sales efforts, agents and telemarketing. Our direct sales force focuses on selling CopperNet connectivity to small- and medium-sized businesses and consulting services and network services to medium- and large-sized businesses. We indirectly sell our full complement of products and services, including our network services, consulting services and products, through network service providers, including ISPs, long distance and local carriers and other networking services companies. Our sales and marketing expenses have increased, and will continue to increase, as we develop our CopperNet services.
- *General and administrative expenses.* As we expand our network, we expect the number of employees located in specific markets to grow. Certain functions, such as customer service, network operations, finance, billing and administrative services, are likely to remain centralized in order to achieve economies of scale. We pay licensing fees for standard systems to support our business processes, such as billing systems.

### *Amortization of deferred compensation on stock options*

We had outstanding stock options to purchase a total of 10,499,338 as of March 31, 2000 and 10,972,791 shares of common stock as of December 31, 1999, respectively, at weighted average exercise prices of \$4.40 and \$2.27 per share, respectively. At March 31, 1999, 10,125,088 of these options were exercisable into restricted shares of our common stock that generally vest over a three- to four-year period. In certain instances, we determined the fair value of the underlying common stock on the date of grant was in excess of the exercise price of the options. As a result, we recorded deferred compensation of \$9.0 million and \$11.9 million for the three months ended March 31, 2000 and 1999, respectively. We recorded this amount as a reduction to stockholders' equity that is amortized as a charge to operations over the vesting periods. For the three months ended March 31, 2000 and 1999, we recognized \$1.7 million and \$540,000 of stock compensation expense, respectively, related to these options.

### *Depreciation and amortization*

Depreciation expense arising from our network and equipment purchases for our customers' premises will be significant and will increase as we deploy our network. Collocation fees, build-out costs, including one-time installation and activation fees, and other DSL-based equipment costs are capitalized and amortized over a range of two to five years.

## Interest Income (Expense), Net

Interest income (expense), net, primarily consists of interest income from our cash and cash equivalents and short-term investments less interest expense associated with our debt and capital leases. As our capital expenditures increase, we anticipate that our interest expense associated with our capital leases will increase.

## Results of Operations

The following tables present our results of operations data and the components of net income (loss) in dollars and as a percentage of our revenue. (See Note 7 of Notes to Financial Statements for certain additional financial information about industry segments.)

	For the three months ended March 31,	
	2000	1999
Revenue:	(in thousands)	
Product sales and consulting services .....	\$ 4,742	\$ 4,657
Network services .....	<u>1,684</u>	<u>119</u>
Total revenue .....	<u>6,426</u>	<u>4,776</u>
Cost of revenue:		
Product sales and consulting services .....	4,056	3,834
Network services .....	<u>3,981</u>	<u>171</u>
Total cost of revenue .....	<u>8,037</u>	<u>4,005</u>
Gross profit (loss) .....	<u>(1,611)</u>	<u>771</u>
Operating expenses:		
Selling, general and administrative .....	14,930	2,533
Amortization of deferred compensation on stock options .....	1,699	540
Depreciation and amortization .....	<u>3,868</u>	<u>187</u>
Total operating expenses .....	<u>20,497</u>	<u>3,260</u>
Loss from operations .....	(22,108)	(2,489)
Interest income (expense), net .....	374	(9)
Follow-on offering costs .....	<u>(574)</u>	<u>—</u>
Net loss .....	<u>\$ (22,308)</u>	<u>\$ (2,498)</u>

	For the three months ended March 31,	
	2000	1999
Revenue:	(percentage of revenue)	
Product sales and consulting services .....	73.8%	97.5%
Network services .....	<u>26.2</u>	<u>2.5</u>
Total revenue .....	<u>100.0</u>	<u>100.0</u>
Cost of revenue:		
Product sales and consulting services .....	63.1	80.3
Network services .....	<u>61.9</u>	<u>3.6</u>
Total cost of revenue .....	<u>125.0</u>	<u>83.9</u>
Gross profit (loss) .....	<u>(25.0)</u>	<u>16.1</u>
Operating expenses:		
Selling, general and administrative .....	232.4	53.0
Amortization of deferred compensation on stock options .....	26.4	11.3
Depreciation and amortization .....	<u>60.2</u>	<u>3.9</u>
Total operating expenses .....	<u>319.0</u>	<u>68.2</u>
Loss from operations .....	(344.0)	(52.1)
Interest income (expense), net .....	5.8	(0.2)
Follow-on offering costs .....	<u>(8.9)</u>	<u>—</u>
Net loss .....	<u>(347.1)%</u>	<u>(52.3)%</u>

### Three Months Ended March 31, 2000 Compared to Three Months Ended March 31, 1999

*Revenue.* We recognized \$6.4 million in revenue for the three months ended March 31, 2000, as compared to \$4.8 million for the three months ended March 31, 1999, an increase of \$1.6 million. This increase was attributable to a \$1.6 million increase in network services, which increased from \$119,000 for the three months ended March 31, 1999 to \$1.7 million for the three months ended March 31, 2000. This was the result of increased sales of services related to our DSL-enabled network introduced in early 1999. Product sales and consulting services revenue were \$4.7 million for the three months ended March 31, 2000 and 1999.

*Cost of revenue.* Cost of revenue was \$8.0 million for the three months ended March 31, 2000, as compared to \$4.0 million for the three months ended March 31, 1999, an increase of \$4.0 million. The increase was principally attributable to growth in cost of network services of \$3.8 million associated with expenses incurred to continue to expand, develop and operate our CopperNet and other networking services. Costs related to product sales and consulting services were \$4.1 million and \$3.8 million for the three months ended March 31, 2000 and 1999, respectively.

*Gross profit (loss).* Gross loss was \$1.6 million for the three months ended March 31, 2000, as compared to gross profit of \$771,000 for the three months ended March 31, 1999, a decrease of \$2.4 million. This loss was primarily a result of increased network services costs related to the continued expansion, development and operation of our CopperNet network. As a result of the rapid expansion, development and operation of our CopperNet network, expenses have exceeded our revenue realized from our customer base.

*Selling, general and administrative expenses.* Selling, general and administrative expenses were \$14.9 million for the three months ended March 31, 2000, as compared to \$2.5 million for the three months ended March 31, 1999, an increase of \$12.4 million. This increase as a percentage of revenue was primarily due to increased staffing and other expenses incurred to develop, operate and sell our CopperNet network and other networking solutions.

*Amortization of deferred compensation on stock options.* Amortization of deferred compensation was \$1.7 million for the three months ended March 31, 2000, as compared to \$540,000 for the three months ended March 31, 1999, an increase of \$1.2 million. This increase is attributable to the increase in the unamortized deferred compensation from \$14.9 million to \$25.6 million as of March 31, 1999 and 2000, respectively, which is principally due to the granting of stock options to key employees, and the related amortization of this increased balance over the remaining vesting period for these options.

*Depreciation and amortization expense.* Depreciation and amortization expense was \$3.9 million for the three months ended March 31, 2000, as compared to \$187,000 for the three months ended March 31, 1999, an increase of \$3.7 million. This increase was primarily due to investments in our CopperNet network, computer equipment and software, office furnishings and leasehold improvements.

*Loss from operations.* Our loss from operations was \$22.1 million for the three months ended March 31, 2000, as compared to \$2.5 million for the three months ended March 31, 1999, an increase of \$19.6 million. The increased loss for the three months ended March 31, 2000 was primarily due to increased staffing, amortization of deferred compensation and other operating expenses we incurred in connection with the expansion, development, operation and support of our CopperNet network.

*Interest income (expense), net.* For the three months ended March 31, 2000, we recorded net interest income of \$374,000, consisting of interest income of \$1.1 million and interest expense of \$(768,000). For the three months ended March 31, 1999, we recorded net interest expense of \$(9,000), consisting of interest income of \$54,000 and interest expense of \$(63,000). The increase in interest income was primarily attributable to interest earned from the net proceeds of \$149.8 million from our preferred stock offering in March 2000. The increase in interest expense is primarily due to interest on capital leases that commenced during 1999 and additional borrowings in March 2000.

*Follow-on offering costs.* During the three months ended March 31, 2000 we expensed \$574,000 related to our follow-on offering of common stock that we commenced earlier in the quarter but subsequently withdrew due to unfavorable market conditions. There were no similar costs during the comparable period in 1999.



*Net loss.* For the foregoing reasons, our net loss was \$22.3 million for the three months ended March 31, 2000, as compared to a net loss of \$2.5 million for the three months ended March 31, 1999, an increase of \$19.8 million.

## **Liquidity and Capital Resources**

Although we do not require significant capital expenditures for our product sales and consulting services segment, the development and expansion of our CopperNet network requires significant capital expenditures. The principal capital expenditures that we expect to incur during our CopperNet rollout include the procurement, design and construction of our collocation spaces and the deployment of DSL-based equipment in central offices and connection sites. Capital expenditures were \$55.3 million for the year ended December 31, 1999 and \$17.5 million for the three months ended March 31, 2000. During the rest of 2000 and for future periods, we expect our capital expenditures to increase substantially primarily due to:

- continued collocation construction in the northeastern and mid-Atlantic regions and new collocation construction in the southeastern and western regions;
- procurement of software systems; and
- the purchase of telecommunications equipment for expansion of our network.

Our capital expenditures will depend in part upon obtaining adequate demand for our services from our CopperNet customers. We anticipate capital expenditures during the rest of 2000 to range from \$80.0 million to \$95.0 million for the expansion of our network from 477 central offices at March 31, 2000 to approximately 900 central offices by the end of 2000.

*Initial Public Offering.* The net proceeds from our initial public offering, completed in June 1999, were approximately \$81.8 million. As of March 31, 2000, we have used approximately \$70.8 million of these net proceeds. Of this amount, approximately \$31.2 million was used to finance operating losses, approximately \$27.9 million was used to finance capital expenditures for central office installation and collocation fees and approximately \$7.6 million was used to finance capital expenditures for property and equipment. We expect to use approximately one-half of the remaining net proceeds to finance operating losses that we expect to incur as we expand our customer base and network. We expect to use the remaining net proceeds from our initial public offering to finance additional capital expenditures for central office installation and collocation fees and to make payments under lease commitments and for general corporate purposes.

*Borrowings and Sale of Preferred Stock.* In February 2000, we borrowed \$15 million from each of SBC and Telmex until we received regulatory approvals for the issuance of 1,500,000 shares of our Series B Mandatorily Redeemable Preferred Stock (preferred stock) on March 7, 2000. The loans bore interest at a rate of prime plus 2% during the time they were outstanding, and we repaid both loans plus accrued interest in full upon consummation of the preferred stock sale on March 7, 2000. The net proceeds from our sale of preferred stock in March 2000 were approximately \$149.8 million. Of this amount, approximately one-half will be used to finance capital expenditures for central office installation and collocation fees, software systems, other capital equipment and certain operating costs related to expansion of our network into new regions beyond our original target markets. We expect to use the remaining net proceeds from our sale of preferred stock to finance operating losses that we expect to incur as we expand our customer base and network, to make payments under lease commitments and for general corporate purposes.

*Operating Activities.* Net cash used in operating activities for three months ending March 31, 2000 was \$20.5 million. This was primarily the result of operating losses of \$22.3 million attributable to the expansion of our CopperNet network and development of our CopperNet services, but also the result of a decrease in accounts payable of \$3.5 million and an increase in accounts receivable of \$1.7 million. This was partially offset by increases in non-cash expenses for depreciation of \$3.9 million and amortization of deferred compensation on stock options of \$1.7 million, accompanied by an increase in accrued expenses of \$1.6 million.

Net cash provided by operating activities for three months ending March 31, 1999 was \$136,000. This was the result of operating losses of \$2.5 million attributable to the expansion of our network and development of our

CopperNet services, accompanied by an increase in accounts receivable of \$952,000. This was partially offset by an increase in accounts payable of \$3.0 million.

*Investing Activities.* Net cash used in investing activities was \$54.0 million for the three months ended March 31, 2000. This was primarily the result of purchases of short-term investments of \$43.5 million. This was accompanied by the deployment of equipment for our CopperNet services of \$6.9 million and purchases of property and equipment of \$3.5 million.

Net cash used in investing activities was \$5.0 million for the three months ended March 31, 1999. This was the result of the deployment of equipment for our CopperNet services of \$4.3 million and purchases of property and equipment of \$675,000.

*Financing Activities.* Net cash provided by financing activities was \$149.8 million for the three months ended March 31, 2000. This was primarily the result of our preferred stock offering of \$150.0 million and borrowings on notes payable of \$30.0 million. These were partially offset primarily by repayments of notes payable of \$30.0 million and principal payments on capital leases of \$1.4 million.

Net cash used in financing activities was \$70,000 for the three months ended March 31, 1999. This was the result of principal payments on capital leases.

*Debt and Capital Lease Arrangements.* We currently have debt and capital lease facilities available to us of approximately \$125.0 million. Of this amount, Lucent (through its acquisition of Ascend) has provided us with a \$95.0 million capital lease facility to fund acquisitions of certain Lucent equipment, under which \$9.0 million was outstanding as of March 31, 2000. The terms of our capital leases range from three to four years. These leases require monthly lease payments and have an interest rate of 9.5%. Lucent has the right to withdraw or suspend further advances to us if our interconnection agreements with Bell Atlantic are not renewed or are terminated, or if certain key employees terminate their employment with us without competent replacement in the reasonable commercial judgment of Lucent. In addition, we have arrangements with other vendors that permit us to finance up to \$25.0 million of equipment and other assets and \$5.0 million of working capital, under a variety of applicable interest rates ranging from 6.0% to 12.0%. An aggregate of \$20.5 million was outstanding under these arrangements as of March 31, 2000.

*Liquidity Requirements.* We believe that our existing cash and cash equivalents, short-term investments, including the net proceeds of approximately \$149.8 million we received from SBC and Telmex, existing equipment lease financings that have not been fully utilized, and anticipated future revenue generated from operations will be sufficient to complete the current planned build-out of our network in the northeast and mid-Atlantic regions and to begin expansion into the southeastern and western regions during 2000 and to fund our operating losses, capital expenditures, lease payments and working capital requirements into the first quarter of 2001.

We expect our operating losses and capital expenditures to increase substantially primarily due to our network expansion into new markets. We expect that additional financing will be required after 2000 for us to complete our planned network roll-out in the southeastern and western regions. We may seek to finance such future operations through a combination of commercial bank borrowings, leasing, vendor financing or the private or public sale of equity or debt securities. If we were to leverage our business by incurring significant debt, we may be required to devote a substantial portion of our cash flow to service that indebtedness. This cash flow would otherwise be available to finance the deployment of our network. If we are forced to use our cash flow in this manner, we could be forced to delay the capital expenditures necessary to complete our network. Equity or debt financing may not be available to us on favorable terms or at all. Any delay in the deployment of our network could have a material adverse effect on our business.

Our capital requirements may vary based upon the timing and success of our CopperNet roll-out, as a result of regulatory, technological and competitive developments or if:

- demand for our services or cash flow from operations is more or less than expected;
- our development plans or projections change or prove to be inaccurate;

- we accelerate deployment of our network or otherwise alter the schedule or targets of our CopperNet roll-out plan; or
- we engage in any strategic acquisitions or relationships.

### **Recent Accounting Pronouncements**

In June 1999, the Financial Accounting Standards Board issued SFAS No. 137, which delays the effective date of SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities,” which will be effective for our fiscal year 2001. This statement establishes accounting and reporting standards requiring that every derivative instrument, including certain derivative instruments imbedded in other contracts, be recorded in the balance sheet as either an asset or liability measured at its fair value. The statement also requires that changes in the derivative’s fair value be recognized in earnings unless specific hedge accounting criteria are met. We believe the adoption of SFAS No. 133 and SFAS No. 137 will not have a material impact on the financial statements, as the Company does not use any derivative financial instruments.

### **Forward-looking Statements**

Many statements made in this Form 10–Q are forward-looking statements relating to future events and our future performance within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words “expects,” “anticipates,” “intends,” “believes,” or similar language. These forward-looking statements address, among other things:

- our CopperNet deployment plans and strategies;
- development and management of our business;
- our planned relationships with SBC and Telmex;
- our ability to attract, retain and motivate qualified personnel;
- our ability to attract and retain customers;
- the extent of acceptance of our services;
- the market opportunity and trends in the markets for our services;
- our ability to upgrade our technologies;
- prices of telecommunication services;
- the nature of regulatory requirements that apply to us;
- our ability to obtain and maintain any required governmental authorizations;
- our future capital expenditures and needs;
- our ability to obtain and maintain financing on commercially reasonable terms; and
- the extent and nature of competition.

These statements may be found in this section, and in this Form 10–Q generally.

We have based these forward-looking statements on our current expectations and projections about future events based on information available to us on this date, and we assume no obligation to update any forward-looking

statements. However, our actual results could differ materially from those anticipated in these forward-looking statements as a result of risks facing us or faulty assumptions on our part. These include, but are not limited to:

- the nature of our ongoing relationship with Bell Atlantic;
- our success in maintaining the continuity of our interconnection agreements;
- our ability to keep pace with technological innovations within the telecommunications industry;
- our ability to hire and retain key personnel;
- our ability to protect our proprietary rights;
- our ability to successfully market our services to current and new customers;
- our ability to generate customer demand for our services in our target markets;
- market pricing for our services and for competing services;
- the extent of increasing competition;
- our ability to acquire the funds needed to continue to expand our network and to continue to fund our operations;
- the ability of our equipment and service suppliers to meet our needs;
- trends in regulatory, legislative and judicial developments; and
- our ability to manage the growth of our operations.

In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this Form 10-Q may not occur.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

We do not believe that we are currently exposed to material market risks.

## **PART II – OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS —**

We are not currently involved in any legal proceedings that we believe could have a material adverse effect on our business, financial position, results of operations or cash flows. We are, however, subject to state telecommunications regulators, FCC and court decisions as they relate to the interpretation and implementation of the Telecommunications Act of 1996, the Federal Communications Act of 1934, as amended, various state telecommunications statutes and regulations, the interpretation of competitive telecommunications company interconnection agreements in general and our interconnection agreements in particular. In some cases, we may be deemed to be bound by the results of ongoing proceedings of these bodies or the legal outcomes of other contested interconnection agreements that are similar to our agreements. The results of any of these proceedings could have a material adverse effect on our business, financial condition, results of operations and cash flows.

### **ITEM 2. CHANGES IN SECURITIES —**

*Recent Sales of Unregistered Securities.* In March 2000, the Company issued 1,500,000 shares of Series B Mandatorily Redeemable Preferred Stock in a private placement to two accredited investors, at a purchase price of \$100 per share, for an aggregate price of \$150 million. The shares were offered and sold in reliance upon the exemption from registration under Section 4(2) of the Securities Act of 1933, relating to sales by an issuer not involving any public offering.

*Use of Public Offering Proceeds.* The net proceeds from our initial public offering, completed in June 1999, were approximately \$81.8 million. As of March 31, 2000, we have used approximately \$70.8 million of these net proceeds. Of this amount, approximately \$31.2 million was used to finance operating losses, approximately \$27.9 million was used to finance capital expenditures for central office installation and collocation fees and approximately \$7.6 million was used to finance capital expenditures for property and equipment. We expect to use approximately one-half of the remaining net proceeds to finance operating losses that we expect to incur as we expand our customer base and network. We expect to use the remaining net proceeds from our initial public offering to finance additional capital expenditures for central office installation and collocation fees and to make payments under lease commitments and for general corporate purposes.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES —** Inapplicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS —** Inapplicable.

**ITEM 5. OTHER INFORMATION —** Inapplicable.

### **ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K —**

(a) *Exhibits:*

27 Financial Data Schedule

(b) *Reports on Form 8-K:*

None.

## **SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 12, 2000

### **NETWORK ACCESS SOLUTIONS CORPORATION**

By: /s/ JONATHAN P. AUST

Jonathan P. Aust

Chairman and Chief Executive Officer

By: /s/ SCOTT G. YANCEY, JR.

Scott G. Yancey, Jr.

Chief Financial Officer